MORNING BRIEFING
January 16, 2020

Banking on the Trade Deal

The next Morning Briefing *will be sent on Tuesday, January 21.*

See the collection of the individual charts linked below.

(1) Analysts following Financials have low expectations for 2020. (2) Financials stocks rallied last year. (3) JPM/Citi blow past Q4 estimates. (4) Trade deal may boost lending and open Chinese market. (5) Yield curve has reversed its inversion. (6) Q4 fixed-income trading surge will mean tougher comps in 2020. (7) CECL keeps accountants busy. (8) Rally means happy investors but pricey stocks. (9) China gets closer to introducing a digital yuan; Fed's Brainard suggests more gradual change in US.

Financials: Glass Half Full or Half Empty? Wall Street analysts are typically an optimistic bunch. In most years, they start out with rosy expectations for their companies' earnings estimates and trim those estimates as the year progresses. But right now, the number-crunching crew is downright pessimistic about financial stocks' 2020 earnings.

They're calling for a 0.4% decline in S&P 500 Diversified Banks' 2020 revenue and only a 3.8% increase in the industry's earnings (*Fig. 1* and *Fig. 2*). Forecasts for the S&P 500 Investment Banking & Brokerage industry are also sluggish, with calls for revenue to increase by 1.6% and earnings to edge up 4.5% this year (*Fig. 3* and *Fig. 4*). There's a bit more optimism about S&P 500 Regional Banks, which analysts see boosting revenue by 12.3% this year; but analysts call for only a 2.9% improvement in net income (*Fig. 5* and *Fig. 6*).

Earnings estimates for the three industries have been revised downward in recent months. For example, the net earnings revisions index for the Diversified Banks industry was negative over the last three months, with a net 20.8%, 14.0%, and 2.0% of the forward estimates revised down in October, November, and December (*Fig. 7*).

Despite analysts' negativity about 2020 earnings, bank stocks had a banner 2019. The S&P 500 Diversified Banks stock price index rose 37.9%, the Regional Banks index jumped 31.3%, and the Investment Banking & Brokerage index added 25.8% (*Fig. 8*, *Fig. 9*, and *Fig. 10*).

Q4 earnings reports from JPMorgan and Citigroup are proving stock investors' optimism correct. Both banks reported Q4 earnings on Tuesday that were well above the consensus analysts' estimates. JPMorgan's earnings per share of $2.57 represented a 30.0% y/y increase and was 22 cents above the consensus estimate. Likewise, Citigroup's $1.90 per share in Q4 handily beat the $1.84 analysts expected. (Wells Fargo's Q4 earnings plunged as the bank continues to struggle with its fake-account scandal.)

Let's take a look at what may prove analysts right or wrong in 2020:

(1) *Trade deal may boost loan demand*. After rising 6.4% annually since 2010, capital spending in real GDP flattened out last year (*Fig. 11*). Less capital spending leads to a reduction in bank loan demand and partly explains JPMorgan's sluggish 2% y/y increase and 1% q/q increase in commercial and industrial loans. "These companies need less money to pay off receivables and inventory and … equipment," CEO Jamie Dimon said on the bank's conference call. The bank isn't alone in seeing C&I loans plateau. Commercial and industrial loans have been in a flat trend since March 2019 (*Fig. 12*).

Optimistic investors may be hoping loan demand will improve in the wake of the US/China trade accord, assuming that increased trade between the two nations will improve economic activity at home, and boost confidence and spending among executives. "We see some resolution of those issues, and that, combined with the continued consumer strength, leads us to expect to see businesses continue their solid activity," Bank of America's Brian Moynihan said, according to a 1/15 *WSJ* article.

In addition, the US/China trade deal promises "greater access for American firms to China's banking, insurance and other financial sectors," according to a 1/13 *WSJ* article. The opportunity to pitch 1.4 billion consumers financial products is enough to make any banker smile.

(2) *Flat yield curve isn't helpful*. The yield curve's inversion late last year was an earnings headwind. In Q4, JPMorgan's net interest income was $14.3 billion, down $100 million q/q and

down $200 million y/y, according to data from the bank. JPMorgan's CFO forecast net interest income to be flat to slightly down in 2020, though she does expect balance-sheet growth.

Optimists, however, could note that the yield curve's inversion has reversed, and there's now a 29bpt spread between the 10-year Treasury and the federal funds rate (*Fig. 13*). If the spread can remain in positive territory this year, that should make for easier comparisons to 2019.

(3) *Market booms tend to be transitory.* Q4 results were saved by a surge in fixed-income trading and, to a lesser extent, by the asset management arms of the banks and brokers. At JPMorgan, Fixed Income Markets Q4 revenue of $3.4 billion jumped 86% y/y. Likewise at Citigroup, Fixed Income Markets revenue increased 49% to $2.9 billion. And at Goldman Sachs, net revenues in the Fixed Income, Currency and Commodities division were $1.77 billion, 63% higher y/y. The sharp increases in the fixed-income business were helped by the horrible Q4 in 2018, when the market suffered from a sharp panic attack. The lack of such a selloff this year makes y/y comparisons easier. But comparisons will be much tougher in 2020.

Similarly, the strong stock market meant rising asset prices and stronger revenues at firms' asset management divisions. At Goldman Sachs, revenue in the asset management arm rose 52% to $3.0 billion.

(4) *Sharpen your pencils.* Starting this quarter, banks will implement a new accounting rule that will change how they account for current expected credit losses (CECL). Banks will have to reserve for expected losses anticipated over the lifetime of the loan instead of only the losses anticipated over the next 12 months, which is the current standard.

"Analysts at Keefe, Bruyette & Woods forecast a median 36% reserve increase for the companies they cover, translating into a 7% increase in 2020 [loan loss] provision expenses, and around a 1% drag on earnings per share," a 1/2 *WSJ* article reported. While analysts may need to factor CECL into their estimates, investors—particularly those able to invest long-term—may be looking past the accounting change, as CECL shouldn't change the total amount reserved over the life of the loan. It just impacts the timing of when the reserve is recognized.

(5) *Too far, too fast?* What should concern investors and analysts is that some banking stocks have entered nosebleed territory. JPMorgan shares, at $138, trade at more than twice the

bank's $60.98 tangible book value per share. Likewise, Citi trades at a more reasonable 1.2 times its tangible book value of $70.39 per share. JPMorgan's CFO Jennifer Piepszak appeared to imply on the conference call that if the stock continues to climb, the bank will look at alternative ways to return capital to shareholders instead of buying back its stock, as it has been doing aggressively. JPMorgan spent $6.7 billion on net share repurchases in Q4 and reduced its outstanding diluted shares by 198 million over the course of the year, which brought its share count down to 3.2 billion.

Disruptive Technologies: Here Comes the Bit-Yuan. The world's first government-sanctioned digital currency may arrive this year. China has completed the "top-level design, formulation, functional research and testing of the Digital Currency Electronic Payment" but it hasn't announced a formal launch date, according to a 12/22/19 article in the *South China Morning Post*. The value of the digital currency will be directly tied to the yuan and not open for speculation like other cryptocurrencies.

Consumers using China's digital wallet would interact directly with the central bank and would no longer need a bank account to hold currency or execute transactions. China's citizens are already accustomed to making purchases digitally, with more than 600 million Chinese people using Alipay or WeChat. However, those accounts are linked to banks.

The Chinese government hopes a digital yuan will help the government battle money laundering, terrorism financing, and tax evasion, according to this 1/2 *WSJ* video. But a government-run digital currency could also give the government even greater control over its people.

If the digital yuan is successful, it could gain international use and theoretically challenge the dollar's global dominance. That would be ironic because it was reportedly the potential of Facebook introducing Libra and dominating the market of global currencies that prompted China to accelerate the development of the digital yuan. Facebook's access to a third of the world's population makes it a viable contender if it launches Libra.

Fed officials are also studying the potential for digital currencies. In a 12/18/19 speech in Frankfurt, Germany Fed Governor Lael Brainard noted that there are a number of risks Libra and other stable coins could face. Fraud and hacking top the list. US consumers are accustomed to having their bank deposits insured by the government up to a specific amount, guaranteeing their safety.

In addition, Facebook wouldn't be tracking people's payments the way the Chinese government might. That means that illicit transactions could occur. "One study estimated that more than a quarter of bitcoin users and roughly half of bitcoin transactions, for example, are associated with illegal activity," Brainard said.

Brainard seemed to lean toward amending the US's payments system instead of radically changing it: "A more relevant question may be whether some intermediate solutions may be able to offer the safety and benefits of real-time digital payments based on sovereign currencies without necessitating radical transformation of the financial system. In the United States, there are important advantages associated with current arrangements. Physical cash in circulation for the U.S. dollar continues to rise due to robust demand, and the dollar plays an important role as a reserve currency globally. Moreover, we have a robust and diverse banking system that provides important services along with a widely available and expanding variety of digital payment options that build on the existing institutional framework with its important safeguards."

Instituting a digital dollar would "raise profound legal, policy and operational questions," in Brainard's view. For now, the Fed is opting to introduce a faster, lower-cost US payments system and recognizes the importance of reducing the cost and friction involved with cross-border payments. US bankers should be relieved, for now.

Corrections: Back to the Future. On Tuesday, we inadvertently wrote about a panel discussion with Ben Bernanke, Janet Yellen, and Jerome Powell as though it occurred recently. It actually happened at the beginning of last year. That's when Powell talked about being "patient" about any further rate hikes. Our point was that he and his colleagues at the Fed are back in patient mode. We also had a typo yesterday: The S&P 500 is up 53.4% since Trump was elected, not 153.4%, through Tuesday's close.

CALENDARS

US: Thurs: Retail Sales Headline, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.5%/0.4%/0.3%, Business Inventories -0.1%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 3.6, NAHB Housing Market Index 74, Import Prices 0.3%m/m/0.5%y/y, EIA Natural Gas Report. **Fri:** Headline & Manufacturing Industrial Production -0.1%/0.1%, Capacity Utilization 77.1%, Housing Starts & Building Permits 1.380mu/1.460mu, Consumer Sentiment Total, Present Situation, and Expectations Indexes 99/115/89, Job Openings 7.265m, Baker-Hughes Rig Count, Harker. (DailyFX estimates)

Global: Thurs: European New Car Registrations, Germany CPI 0.5%m/m/1.5%y/y, China GDP 1.4%q/q/6.0%y/y, China Retail Sales 7.9% y/y, China Industrial Production 5.9% y/y, BOE Bank Liabilities/Credit Conditions Report, BOE December Meeting Minutes, Lagarde. **Fri:** Eurozone Headline & Core CPI 1.3%/1.3% y/y, UK Retail Sales Excluding & Including Auto Fuel 3.0%/2.7% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose to 3.20 this week after falling from 3.34 to 3.10 the prior two weeks—its12th straight reading above 3.00. Once again, there were wide swings in bullish sentiment and the correction count. Bullish sentiment rose 1.9ppts to 57.0% this week, after falling 3.8ppts to 55.1% last week, while the correction count fell 1.9ppts to 25.2% after rising 3.8ppts to 27.1% over the comparable periods. Over the previous two weeks, bullish sentiment rose 5.6ppts (to 58.9% from 53.3%), while the correction count fell 6.2ppts (23.3 from 29.5). Bearish sentiment was at 17.8% for the third week, continuing to fluctuate in a narrow band. The AAII Ratio fell for the third week last week, from 68.3% to 52.5%, with bullish sentiment sliding from 44.1% to 33.1% over the period and bearish sentiment rising from 20.5% to 29.9%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings both edged down last week. However, they remain near their record highs a week earlier, which had been their first since early October. Analysts expect forward revenues growth of 4.9% and forward earnings growth of 9.4%, with the earnings measure down 0.1ppt w/w. Forward revenues growth is at a 40-month low and 1.4ppt from a seven-year high of 6.3% in February 2018. Forward earnings growth is down 7.5ppts from a six-year high of 16.9% in February 2018 but is still comfortably above its 34-month low of 5.9% in February 2019. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenues growth to slow from 8.5% in 2018 to 4.1% in 2019 and 4.9% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 1.0% in 2019 before improving to 8.9% in 2020. The forward profit margin remained steady w/w at 12.0%, which is up 0.1ppt from a 22-month low of 11.9% in late December and is down only 0.4ppt from a record high of 12.4% in September 2018. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts are expecting the profit margin to drop 0.4ppt y/y from 11.8% in 2018 to 11.4% in 2019 before improving to 11.9% in 2020. The S&P 500's forward P/E rose 0.1pt to a 24-month high of 18.4. That's up from 14.3 during December 2018, which was the lowest reading since October 2013 and down 23% then from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio gained 0.02pt w/w to a record high of 2.21. That's up from 1.75 during December 2018, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Consensus forward revenues rose w/w for 7/11 S&P 500 sectors last week and forward earnings was higher for three. Financials, Real Estate, and Information Technology had both measures rise w/w. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward P/S and P/E ratios remain near record or cyclical highs for Communication Services, Consumer Discretionary, Information Technology, Real Estate, and Utilities. Health Care's valuation has only recently improved from its multi-year low during December 2018. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. All sectors except Real Estate are expected to record higher margins y/y in 2020, up from just two sectors improving y/y in 2019: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all the sectors. Utilities is the only sector with its forward profit margin at a record high. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.7%, down from 23.0%), Financials (18.1, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (13.3, a new record high this week), S&P 500 (12.0, down from 12.4), Health Care (10.5, down from 11.2), Industrials (10.4, down from its record high of 10.5% in mid-December), Materials (10.2, down from 11.6), Consumer Discretionary (7.4, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.3, down from 8.0).

US ECONOMIC INDICATORS

Regional M-PMI (*link*): The New York Fed—the first district to report on manufacturing activity for January—showed activity grew at its best pace since last May, though remained sluggish.

The composite index increased for the third time in four months, from 2.2 last September to an eight-month high of 4.8 this month. The new orders (to 6.6 from 1.7) index showed billings picked up during the month, while the unfilled orders (-2.7 from -13.8) measure remained negative, though is fast approaching positive territory. Shipments (8.6 from 9.5) continued to grow at a steady pace, while delivery times (-2.7 from -5.8) shortened and inventories (-0.7 from 2.2) held relatively steady over the month. Employment (9.0 from 10.4) continued to expand at a solid rate after falling last summer, while the average workweek (1.3 from 0.7) measure was little changed. Both the prices paid (31.5 from 15.2) and prices received (14.4 from 4.3) indexes showed inflationary pressures accelerated for the first time in four months in January—rising at their best paces since last March. Meanwhile, the six-month outlook remained restrained as the index for future business conditions (to 23.6 from 26.1) eased a bit, though future shipments (32.7 from 27.9) and new orders (31.4 from 30.8) continued to improve. The capital expenditures (25.3 from 26.1) index held steady, and technology spending (22.6 from 27.5) remained around recent highs.

Producer Price Index (*link*): The Producer Price Index for final demand ticked up 0.1% in December after no change in November and a 0.4% gain in October. The yearly rate rose 1.3% y/y, not far from the 1.1% increase in both November and October—which was the lowest yearly rate since October 2016; it peaked at 3.4% y/y during July 2018. Prices for final demand goods increased 0.3% for the second month, less than half October's 0.7%, with gasoline prices accounting for over 60% of December's increase. The yearly rate (1.1% y/y) moved further above zero from its recent low of -0.6% recorded in October. Meanwhile, prices for final demand services were flat in December after falling 0.3% in November, with the yearly rate sinking to 1.3% y/y—the lowest since March 2017. The rate was at 3.0% at the end of 2018. Meanwhile, there's deflation in the pipeline: Intermediate goods prices fell 1.7% y/y in December, though was up from October's 40-month low of -3.7%. Crude prices fell 7.3% y/y last month—its 12th consecutive negative reading.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (*link*): Output may be finding a bottom, posting only one loss during the four months through November. Output ticked up 0.2% in November after a 0.9% drop in October, though remained flat over the four-month period. Output had contracted 2.0% over the prior six-month period. Production of capital goods expanded for the fourth time in five months, by 1.2%m/m and 2.2% over the period. Meanwhile, both consumer durable (-0.8%) and consumer nondurable (-0.7) goods output dipped in November, but are up 1.2% and 1.6%

y/y, respectively. Intermediate goods output continued its up-and-down pattern, dropping 0.5% in November. Of the top four Eurozone economies, output in Spain and France climbed 1.1% and 0.3% m/m, respectively, with both above year-ago levels by 2.1% y/y and 1.2%. Meanwhile, production increased in both Germany (0.9% m/m & -4.0% y/y) and Italy (0.1 & -0.6) in November but remained below year-ago levels—though declines in both are narrowing.

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